

FA Module 7: Financial analysis techniques (overview)

(The attached PDF file has better formatting.)

Reading: chapter 7 Financial analysis techniques

- § 4 common ratios used in financial analysis, *excluding*
 - Example 10 (Bounds and context of financial measures)
 - Example 11 (Alcatel-Lucent)
 - Example 12 (Daimler AG)
 - Example 13 (A variety of ratios)
 - Example 14 (A comparison two companies - 1)
 - Example 15 (A comparison two companies - 2)
- § 5 equity analysis, *excluding*
 - sub-section 5.2 (industry-specific ratios)
 - sub-section 5.3 (research on ratios in equity analysis)
- § 6 credit analysis, *excluding*
 - sub-section 6.2 (research on ratios in credit analysis)

[§§2, 3, 7, and 8 are not on the syllabus for this course.]

Final exam problems for many modules test financial ratios. A problem on finance leases may test the debt-to-equity ratio at end of the second year of the lease, or the return on equity for the second year. Some problems give a financial ratio and ask for the accounting entry. A problem may give the receivables turnover and the net revenue and ask for the change in the accounts receivable.

Know the activity ratios, liquidity ratios, solvency ratios, profitability ratios, and valuation ratios. The textbook has exhibits showing the numerator and denominator for each ratio.

Section 4.6.2 (DuPont Analysis: the decomposition of ROE) is tested on the final exam. Focus on the five-way decomposition, and be able to derive each of the five parts from the others.

In general, ratios using balance sheet entries only at for the balance sheet date, and ratios combining balance sheet entries with income statement entries use averages.

- The debt-to-equity ratio uses year-end balance sheet entries. The final exam problem may say “the debt-to-equity ratio for December 31, 20X2.”
- The return on equity uses net income for the year divided by the average of beginning and end of the year shareholders’ equity. The final exam problem may say “the return on equity for 20X2.”

The CFA textbook has many sections on interpretation (financial analysis) of ratios, such as trend analysis, regression analysis, and common size analysis. Actuarial candidates learn statistical analysis on other exams. The final exam tests whether you can derive the financial ratio, not how you interpret the rate.

Section 5 on equity analysis presents various ratios related to common shares. The final exam tests basic EPS (earnings per share) and diluted EPS. Know how to form diluted EPS for convertible securities (bonds and preferred stocks) and stock options. Issue of new shares, repurchase of shares, and stock dividends may affect both basic and diluted EPS.

Almost all insurers (and banks) have financial strength credit ratings. Section 6, credit analysis, discusses the credit rating process and the economic structure of the credit rating industry.